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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 000249

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TAGS: [ECON](#) [EPET](#) [PGOV](#) [PREL](#) [AJ](#)  
SUBJECT: AZERBAIJAN IN 2006 LOOKS TO SOLIDIFY ITSELF AS  
REGIONAL ENERGY PLAYER

REF: (A) BAKU 152 (B) 05 BAKU 1918 (C) BAKU 197

Classified By: Ambassador Reno L. Harnish III, Reasons 1.4(b) and (d).

¶1. (C) SUMMARY: With the completion of the Baku-Tbilisi-Ceyhan oil pipeline scheduled for late May and the South Caucasus Pipeline scheduled for October, Azerbaijan in 2006 looks to solidify itself as a regional energy hub and energy provider to foreign markets, including Europe. Over the next decade, Azerbaijan oil and gas capabilities will expand and flourish and it has the potential to become a major hub for oil and gas. Many internal factors, however, will influence whether Azerbaijan can take full advantage of this opportunity. Domestic politics, internal bickering and political vision, will ultimately affect Azerbaijan's ability to stay at the forefront of energy exploitation and distribution to international markets, including diversifying European gas supplies away from reliance on Russia. These goals also serve U.S. strategic interests and Azerbaijan should be encouraged to pursue them. END SUMMARY.

#### Azerbaijan as International Source of Energy

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¶2. (C) With BTC finally nearing completion after significant delays (REF A) and oil scheduled to reach Ceyhan in late spring, Azerbaijan's energy clout and economic resources will quickly increase. On the heels of BTC, the South Caucasus Pipeline (SCP), also known as the Baku-Tbilisi-Erzurum gas pipeline, is scheduled to come online in late October 2006 and Shah Deniz gas, at least eight billion cubic meters of gas, will begin flowing to Turkey. By Phase II, Shah Deniz will send approximately 16 billion cubic meters of gas a year to Turkey, and possibly beyond. Both BTC and SCP raise Azerbaijan's international geopolitical profile and highlight its role in providing Western energy markets with diverse supplies (i.e. non-Russian or non-Iranian).

¶3. (C) Presidential Energy Advisor Ali Asadov told PolEcon Couns that the Shah Deniz gas field may hold as much as two trillion meters of gas and that he could envision Azerbaijan building a second pipeline parallel to SCP to send additional gas to Europe. Asadov indicated that Azerbaijan needed to double its potential production to 30 to 40 bcm per year. Asadov's comments were not the first time that we have heard such unproven high estimates for Shah Deniz gas reserves (REF B). Asadov also noted that with future Azerbaijani gas demands reaching 15 to 20 billion cubic meters a year, there will plenty of additional gas to send to European markets (assuming Azerbaijan can produce and send 35-40 bcm per year). Asadov argued that it was in Europe's interest to buy Azerbaijani gas in order to lessen GAZPROM and Russia's monopoly over gas supplies to Europe.

14. (C) Both BP and Statoil executives in Baku openly discuss the possibility of a second pipeline to further tap the Shah Deniz reservoir. Without another way to exploit Shah Deniz, after Phase II development the gas field will end up primarily serving the domestic needs of Azerbaijan and Georgia, with a small amount for export. But with a second pipeline, Azerbaijan could both meet projected domestic demand and still be a major exporter to Europe. Recent Russian behavior and Iranian rhetoric have created a window of opportunity in Europe that Azerbaijan could exploit.

15. (C) Azerbaijan has already begun to play an emerging role in international energy politics. During the January energy crisis in Georgia, Azerbaijan quickly came to its Caucasus neighbor's aid and supplied 2.4 million cubic meters of gas a day. Newly appointed Minister of Energy and Industry and former SOCAR president, Natiq Aliyev, played a critical role in organizing the GOAJ's response to the crisis and also coordinating multiple ministries and agencies. In addition, Azerbaijan facilitated Iranian gas transiting to Georgia during the crisis. Allowing Iran to send gas to Georgia, a natural market for Azerbaijani gas, shows one facet of the GOAJ's delicate balance with its regional rivals - Iran and Russia.

16. (C) Being situated between Russia and Iran, the GOAJ is keenly aware of the importance of balancing its relationship with Russia. In 2005, Azerbaijan agreed to buy Russian gas at higher prices over the next coming years even though Azerbaijan may not need the gas with the start of Shah Deniz. Azerbaijan also allowed Georgia and Iran to sign an agreement to send gas through Azerbaijan to Georgia. Asadov

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downplayed the benefits of the deal to Azerbaijan, noting that Iran provided Georgia with only 3.65 million cubic meters of natural gas that transited Azerbaijan and the GOAJ had levied only USD 10 per thousand meters as transit fees (REF C). Many GOAJ energy officials openly note that, compared to Russia and Iran, Azerbaijan's energy and political resources are limited and so it must be a "good neighbor" in order to stay out of trouble.

Kazakhstan Oil, BTC and the Inter-Government Agreement

17. (C) A key part of Azerbaijan's growing regional energy role is the long-discussed project to ship Kazakhstan's oil and gas to Western markets through BTC and SCP. The inter-governmental agreement which would facilitate this, however, remains stalled. American and international energy executives told Ambassador Harnish that international pressure from abroad (i.e. the U.S.) is required to break the impasse and to sign the deal. The same contacts noted, however, that Azerbaijan reportedly wants to renegotiate the IGA, potentially stalling the agreement even further. Former SOCAR executive, now Deputy Speaker, Valekh Alasgarov, reportedly is pushing this renegotiation. He is allegedly taking his cues directly from President Aliyev. In terms of other regional projects, there is talk about bringing Central Asian gas into SCP. Generally, Kazakhstan is mentioned as the likely partner rather than Turkmenistan. Many in the international energy community in Baku still see Turkmenistan in terms of the failed TCP project of some years ago, and are skeptical that a new project would proceed any differently.

18. (C) Reportedly, President Aliyev thinks Azerbaijan deserves a better deal due to its emerging role as a vital transit country. He also is reportedly still irritated with Kazakhstan President Nazarbayev for the latter's last-minute refusal to sign an IGA in May at the BTC First Oil ceremonies. Previously, international companies did not seem worried about the slow progress of the IGA. Now, as the date when their Kashagan production will require an outlet comes closer and closer, some are beginning to express concern. It

is unclear how progress on the IGA will affect the smaller-scale project to bring Kazakhstan's Tengiz oil into BTC, which is expected to start as early as 2007.

#### Will the Lack of Energy Coordination Hurt the GOAJ?

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¶9. (C) Azerbaijan's ambitious plans to expand its regional goals clash with the GOAJ's recent reorganization of SOCAR, the Energy and Industry Ministry and the move of energy-guru Valeh Alasgarov to Parliament. At a meeting with Ambassador Harnish, U.S. and international energy executives characterized the move of Natik Aliyev from SOCAR to Minister of Energy and Industry as a lateral promotion. Aliyev was reportedly upset at his appointment and complained that the GOAJ did not appreciate his work. In addition, most energy observers had initially expected Aliyev to play a more active role in Azerbaijan's energy affairs, even corralling all of the energy players, including SOCAR, into the Energy Ministry. This scenario, however, appears to have not played out and Aliyev has openly said that he devote more of his time to the industry part of his portfolio.

¶10. (C) SOCAR's new President, Rovnaq Abdullayev, arrived with plans to reorganize and restructure the state-owned company. He quickly created several new vice president positions and appointed several confidants in key positions. Several of his deputies are politically connected and influential. Energy executives remark that Abdullayev would like to remake SOCAR into an internationally competitive firm, such as Statoil of Norway. SOCAR's new management, however, appears paralyzed and unable to make decisions. This paralysis may be short-term and some energy executives note that SOCAR will probably increase its influence and power in energy decision-making. Abdullayev's efforts to reorganize SOCAR into an internationally competitive company would be a positive step forward and could lead to greater transparency at the company.

¶11. (C) The one wild card in Azerbaijan's energy politics is the role of Valekh Alasgarov, formerly the foreign investments chief of SOCAR and now one of parliament's three deputy speakers. It appears that Alasgarov's move to Parliament has not meant his removal from energy politics -- indeed, he chairs parliament's energy committee. Several

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energy executives believe that Alasgarov will play an ad hoc role in energy policy, and his apparent role in the IGA process on behalf of President Aliyev bears this out. With the relationships undefined among these three powerful individuals -- Natik Aliyev, Alasgarov and Abdullayev -- there is a void in Azerbaijan's energy affairs. Until a new division of responsibilities is agreed upon, Azerbaijan's energy policy will likely emerge from a process of trade-offs and impromptu decisions.

#### Projects End & Int'l Companies Think of Future

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¶12. (C) The lack of coordinated GOAJ energy policy, much like general economic decision making in the government, has put at risk Azerbaijan's regional energy hub role and its competitive advantage. American and international oil executives noted to Ambassador Harnish that with BTC and Shah Deniz projects in Azerbaijan nearing completion and the GOAJ unable to focus on future projects, many companies will move on to other countries and new projects. In addition, the domestic core of trained professional Azerbaijanis are leaving for other countries, such as Russia, to work in the petroleum sector. This double negative on the Azerbaijani energy sector could have a tremendous effect on the country's ability to exploit future energy resources and retain the necessary technical capacity. One executive noted that Azerbaijan needed to create duty free zones for international companies to spur greater investment. He cited Azerbaijan's

export tax as a penalty and one of the impediments to competition.

¶13. (C) Despite the recent internal GOAJ upheavals, Azerbaijan in 2006 will solidify its regional and international role as an energy hub and supplier. Its long-term success, however, depends on whether it can focus on long-term goals and projects. The completion of the BTC and SCP projects may have moved Azerbaijan's focus from future exploitation projects to reaping the economic benefits now. The country has already begun to feel the effects of its oil wealth without preparing its financial and economic systems. If the GOAJ loses focus on energy transit issues, Azerbaijan's role as a regional energy hub may come to a close over the next ten to fifteen years. The ACG oil field will be exhausted, and Shah Deniz will be meeting primarily the domestic needs of Azerbaijan and Georgia, with a small amount left for export. If the GOAJ focuses on bringing Central Asian oil and gas into its pipelines, and also exploits the full potential of Shah Deniz, Azerbaijan can look at being an energy hub well towards the middle of the century. Given that this would contribute to economic stability in the south Caucasus, diversify world oil supplies and diversify European gas supplies away from relying on Russia and/or Iran, the United States should support Azerbaijan's efforts to play this role.

HARNISH